

The Bulgarian Economy at the End of the First Semester of 2007

Macro-economic Dynamics

↑
Positive
Expectations
for GDP Growth

Expectations for accelerated rates of general economic growth throughout 2007 are based on the good results of the first quarter of the year. This becomes also evident from the conjuncture indicators showing retention of the record high levels of the general business climate indicator in the economy. In the four industrial sectors under observation the business climate levels keep on exceeding the levels of the same period of last year. The indicator “consumer confidence” is also improving, and the growth of industrial output is increasing.

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High
Business
Climate
Indicator

By June 2007 **the general business climate indicator** in the economy¹ is still maintained by about 30 percentage points above its long-term value and is by almost 20 percentage points higher than in June 2006. The still record good levels of business climate are being maintained, and in the largest sectors (industry and services) an increase is even observed. **Consumer confidence** is significantly improved compared to weaker changes in previous observations (for April 2007 this indicator is by almost 8 points above the last January value). Expectations of urban households prevail, however, rural households also have positive opinions.

↑
Acceleration
of Growth
in Industry

What is observed for the first five months of 2007 is a certain **acceleration of the growth rates of production in industry**. Although on an annual basis industrial sales grow somewhat slower compared to their growth for the same period of last year (8.6 per cent and 8.7 per cent, respectively), the growth is accelerated to 8 per cent, versus 7.2 per cent for the same period of last year. Utilization of capacities in industry keeps on retaining high levels and meets the expectations of the business in this sector for the good condition of enterprises during the second semester (53 per cent of the respondents expect retention, and 46 per cent – improvement of the business condition).

The high economic activity of the end of 2006 is sustained at high levels throughout the first semester of 2007. We expect **accelerated general economic growth** for the second quarter (around 6.6-6.7 per cent). We expect that the growth for the whole 2007 will be in this range.

According to preliminary NSI data the real GDP growth for the first quarter of 2007 is 6.2 per cent, versus 5.5 per cent for the same period of last year, and 5.7 per cent for the fourth quarter of 2006. On the side of supply, the dynamics of the value added in the agrarian sector turns from decline to growth and the growth in industry and services is accelerated. On the side of demand the dynamics of GDP is determined by the fast growth of domestic demand. Record high rates compared to the respective period of 2001 have been reached by both investments (35.9 per cent), and individual consumption of households (8.1 per cent).

¹ Source: Economic Situation, NSI Business Surveys, June 2007

At the background of good data of economic growth it is worth noting that the trend of reduction of labor productivity growth persists, and for two consecutive quarters a real decline of the productivity on an annual basis is in place.

During the first quarter of 2007 **the value added in the economy has been growing at accelerated rate** (by 7.7 per cent, versus 6.3 per cent for the same period of last year). The growth of the value added of *the industry sector* is speeded up at 7.6 per cent and though lower than the growth in services, this has been the highest growth in industry for the respective first quarters since 1999. The fastest growing value added in this sector is the one in construction (15.5 per cent), followed by the manufacturing industry (14.5 per cent). Some reorientation is observed of the sales of manufacturing industry to the domestic market – the share of export sales goes down to 39.8 per cent versus 43.5 per cent of last year's total sales. *The services sector* continues to have a higher contribution for the growth of GDP on the side of production compared to the contribution of the industry. The growth of the value added of the sector was accelerated to 8.1 per cent. The most dynamic branch here continues to be financial mediation whose value added growth of 40 per cent accounts for almost half of the total growth of the services sector. *The agrarian sector* marks an increase of the value added by 2.5 per cent, but the unfavorable climatic conditions do not give grounds to expect sustainable recovery of the sector in the short term.

↑
Value
Added in
Economy
Is Growing

Slowing Down
of Export
and Import
Growth Rates



From the perspective of **demand** in the economy, the GDP growth of 6.2 per cent for the first quarter of 2007 is formed by increased contribution of domestic demand (16.4 percentage points) and preserved level of the negative contribution of foreign trade in goods and services (10.2 percentage points). **Investments in authorized capital have the highest positive contribution** (8.4 percentage points) in the total economic growth on the side of total demand, unlike the respective period of last year, when export of goods and services was leading (8.4 percentage points). The real growth of investments reached 35.9 per cent mainly due to the private sector, whose investments amount to around 90 per cent of the total for the first quarter. Consumption keeps its accelerated growth but more smoothly compared to investments. For the first quarter of 2007 its growth is 7 per cent, while the growth of individual consumption is accelerated to 8.1 per cent, and collective consumption records a decline by 2.7 per cent. According to current data on foreign trade the growth of export of goods and services has considerably delayed at hardly 2.2 per cent. Delay is in place also with import, whose growth dropped down to 13.2 per cent. The negative balance in the trade in goods and services continued to grow and reached 28.7 per cent of GDP.

Current
Account
Deficit is
Growing



For the first five months of 2007 the **current account** deficit grows on an annual basis from 7 to 9.7 per cent of the annual GDP. Over 97 per cent of the deterioration of the current account deficit (by EUR 838.6 m) is due to the increased deficit of the trade balance, as well as to the decreased positive balances of current transfers and of net income. A favorable contribution is only the one of the balance of services, which continues to be negative, but is shrinking.

Import
Grows Faster
than Export



The nominal rates of export and import of goods have significantly decreased for the first five months of 2007 compared to those for the same period of 2006 but while with imports the difference in the rates is about two times, with exports this difference is about 5 times (export – 6.7 per cent, versus 30.5 per cent for the first five months of 2006, import –17.4 per cent, versus 29.5 per cent for the same period of 2006). There are many uncertainties at this stage with regard to the data on foreign trade – the relatively weak growth of exports can not be explained only with the limited supplies in certain sectors (electric power, agricultural products). At the same time, a clearly expressed trend is in place of growing investments for expansion of production in a number of export-oriented enterprises and for the construction of new production capacities specially designed for export. Investments are made also in the manufacturing of products substituting imports. All this initially aggravates the situation in the area of imports which continues to grow at accelerated rates. In the end, however, conditions are being created for long-term increase of export and decrease of import.

The growing deficit of the trade balance bears a risk for the economy but at the same time the conviction remains that the major reason for the increasing import (and hence, for the trade deficit) is the accelerated development of the economy and to a much more limited extent – the increased purchasing power of the population. With the expanding trading links of the country with EU, the development of EU economy remains an important factor defining the dynamics of the Bulgarian foreign trade. For the present, forecasts are positive and reality even exceeds expectations – the growth in the Eurozone is expected to reach 2.6 per cent. Given this, foreign trade growth rates will remain high (12-15 per cent on an annual basis). Import will continue to surpass export and we hope that purely statistical deviations will be gradually removed and reporting will come closer to reality.

Among the three components of services (transport, travel and other services) deterioration is observed only with the balance of transport services. The travel balance for the five months from the beginning of the year is preserved positive on an annual basis and slightly increases. Improvement of the negative balance in *Other Services* by around EUR 130 m has a predominant contribution to the though small positive effect of services on the current account deficit.

A major factor for the deterioration of the positive balance of income for the first five months of 2007 are the promptly increased payments of income on direct investments, including payment of dividends to foreign investors. Net revenues from current transfer are decreasing, mainly due to this year's emergence of payments on current transfers to EU, i.e. a portion of the country's contribution into the budget of EU.

Less FDI
compared
to 2006



For the first five months of the year the inflow of foreign direct investments into the country was about 10 per cent lower than for the same period of last

year. The decrease is from EUR 1.7 b to EUR 1.5 b or from 6.8 per cent to 5.7 per cent of GDP. Therefore, the coverage of the currently reported current account deficit for the first five months of 2007 is hardly 59 per cent, versus 96.8 per cent for the same period of last year. The EU accession of the country makes it in general terms less risky and despite the temporary decline of investments, the Bulgarian economy is expected to continue over the following periods to attract the attention of investors. Adding to that the low rate of profit tax and the still low cost of labour, we expect that the inflow of foreign investments will be preserved on a fairly high level.

↑
Moderate
Inflation

The increase of **consumer prices** is more moderate compared to last year. For the first six months since the beginning of 2007 prices of consumer goods and services increased by 2 per cent versus December of last year (with 2.9 per cent accumulated inflation for the same period of 2006 and 6.5 per cent for the whole last year). Higher price rise is reported by the harmonized index of consumer prices (2.8 per cent since the start of the year) and the increase of prices in the small consumer basket is twice lower (1.5 per cent).

On a yearly basis, inflation dropped down to 5.6 per cent for June compared to the same month of last year (8.2 per cent for June 2006 versus June 2005). For the period since the beginning of the year, the highest contribution to the total price change of consumer goods and services is attributed to services (3.7 per cent increase, 1 basic point contribution), followed by non-food commodities (increase of 1.5 per cent, 0.5 percentage points contribution). Lowest price rise and contribution are attributed to food stuffs (increase of 0.9 per cent, contribution to total inflation of 0.3 percentage points); most significant is the price rise in public catering (5 per cent) but due to the small weight of this group its contribution to the total inflation from the start of the year is only 0.2 per cent. The accumulated total price increase for the first semester of 2007 of *specially monitored socially beneficial and vital goods and services*² by 1.5 per cent is formed by almost equal contribution (of 0.5 percentage points each) of the three basic groups of goods and services, included in the small basket (food stuffs, non-food commodities and services).

By April 2007 the monthly dynamics of **producer prices in industry** is relatively weak. A more considerable increase of prices is observed in May. In May 2007 versus May 2006 total producer prices are by 5.4 per cent higher and prices for the domestic market – by 5.5 per cent higher. Compared to the previous year, most substantial is the rise of prices in the energy sectors, metallurgy and food and beverage industry.

NSI business surveys of June 2007 do not manifest expectations for a short-term inflation pressure during the third quarter. There are no inflation

² This is the so called small consumer basket of 100 specially selected goods and services, weighed through the expenses of the 20 per cent lowest income households.

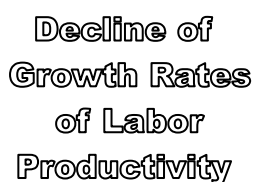
expectations in industry. Both in construction and services over two thirds of the respondents expect that selling prices in the respective sector will remain unchanged. It is only in retail trade where the share of respondents predicting increase of selling prices over the next three months is higher.

Inflation expectations among consumers seem to be calming down. Though respondents continue to be of the opinion that consumer prices are going up, the April monitoring of consumers shows a shift in the expectations of consumers to inflation over the following twelve months from „faster” to „the same” or „slower” rate of price rise which results in a sharp improvement of the balance indicator that goes down by 11.2 percentage points.

Changes in pricing and price levels of electric power under the conditions of a liberalized energy market and pricing in the agrarian sector will have a pro-inflationary impact during the second half of the year.



The acceleration of economic growth from the beginning of 2007 to 6.2 per cent for the first quarter versus 5.5 per cent for the same period of last year is accompanied by a considerably faster **increase of the number of employed** – by 6.6 per cent for the first quarter of 2007 versus 3.6 per cent for the same period of last year. The pace of reduction of the number of unemployed is preserved (13.5 per cent versus 13 per cent for the first quarter of last year). The share of the employed in the total number of participants in the labor market grows to 92 per cent compared to 90 per cent a year earlier. The number of the employed amounts already to 3.1 m people or by 194.9 thousand more than in the first quarter of last year. The number of unemployed goes down by 42.5 thousand to 272.7 thousand people. The reduction of the number of people outside the work force (by 172 thousand down to 3230 thousand in the first quarter of 2007) and of the number of discouraged persons³ (by 97.6 thousand people down to 227 thousand) proves that appropriate jobs emerge in the economy for those individuals who for some period of time have not been participants in the labor market.



The unfavorable trend of **slowing down of the rates of labor productivity in the economy** persists. The acceleration of the total economic growth from 5.5 to 6.2 per cent GDP growth for the first quarter of 2007 versus 2006, as well as of the value added (from 6.3 to 7.7 per cent), is realized with acceleration of the employment rates (from 3.6 to 6.6 per cent) with concurrent deterioration of productivity rates. The rate of value added per 1 employed goes down from 2.6 to 1 per cent, and the GDP rate per 1 employed is even negative already. While for the first quarter of 2006 GDP per 1 employed grows in real terms by 1.8 per cent on an annual basis, for the first quarter of 2007 this indicator drops down by 0.4 per cent.

³ These are persons who wish to work but do not seek jobs actively and as such they are not counted as work force but in the group “individuals out of the work force”



The trend of **decrease of unemployment** continues. Total unemployment goes down to 8 per cent for the first quarter of 2007 compared to 9.7 per cent a year earlier. The share of the unemployed with length of unemployment more than one year in the number of all the unemployed is reduced from 57 to 55.6 per cent, and the coefficient of long-term unemployment (share of long-term unemployed in the economically active population) decreases from 5.5 to 4.5 per cent of the economically active individuals aged 15 plus. Most significant is the decline of the coefficient of unemployment among young people in the age group 15–24, from 20.9 to 16 per cent. May 2007 is the first month in which the coefficient of registered unemployment is below 8 per cent of the economically active population.

ESTAT Index of business climate

Since the beginning of last year we have been observing a lasting trend of improvement of the business environment and the condition of businesses in the country regardless of the weak fluctuations in individual components of the index. For this reason the increase of the July value of the indicator is not surprising. For the current being, expectations of entrepreneurs registered in the survey do not confirm the projections of slowing down of economic growth.



The sectors with most companies in “good health” are financial services, real property transactions and, this is worth noting, developing activities in the area of education, healthcare and social services. By the way, some other indicators also point out to some “motion” in this rather stagnant and undervalued over the years sector.

The survey registers a general and considerable growth of companies’ resources some of which reach record values for the whole period of surveying. These determinations apply mostly to Internet connection whose average valuation has increased for three months only by 0.20 percentage points to the extremely high 5.21. Parallel to this, the share of companies not connected to the web continues to decrease. At the time of conducting the survey, these are only 13 per cent of the sample.

The interest to investment lending is gradually coming back, while the endeavor to risk investments in other than major operations is faster. Those who tend to borrow and invest in the energy sector are most in number, while those in the financial sector, education, healthcare and social services are fairly reserved. Most expansion oriented are those in tourism, finance and mainly in the agrarian sector. At first glance, the willingness of managers in farming to invest in other operations is surprising but in fact it is quite reasonable with regard to their unwillingness to depend on nature and market conjuncture.

Economic Policy

Enterprise policy. Following Bulgaria's accession to the EU, efforts continue towards improvement of the business environment and administrative services to Bulgarian entrepreneurs. Unfortunately, starting up a business and, in particular, registration of companies in Bulgaria still take considerable time and costs. This problem was not resolved with the new Business Registration Act since its enactment was postponed once again. This delay has a negative impact on the business environment and registration procedures of companies.

Administrative
Services to
Companies
Are Not Improving



Regardless of the significant efforts and harmonization of the law with *acquis* in the area of public procurement, this is one of the areas where serious problems exist and a high corruption risk is in place. The level of corruption remains fairly high and impedes the normal development of market relations, distorts competition and limits the inflow of foreign investments.

Measures were undertaken during the last months to further encourage investments. Changes were introduced in the area of investment policy aimed at directing investors' interest to manufacturing operations and alternative energy sources as a priority. Investments in regions of high unemployment and in technologies will receive highest levels of government support. What is crucial for improvement of Bulgarian companies' position in international markets is the increase of their competitiveness which is currently rather low. Bulgaria is still considerably lagging behind in the field of innovations – in 2006 R&D expenditures amount hardly to 0.5 per cent of GDP, the number of innovative enterprises is four times lower than in the EU, particularly low is the degree of commercialization of Bulgarian research and development. The lack of funding is among the major barriers to innovations development. This problem could be overcome to a certain extent with the support of the launched in June first risk investment fund for high-tech products in the market of South-East Europe – New Europe Venture Equity (NEVEQ).

The Country
Is Lagging Behind
with Innovations



In the area of privatization and concessions the Government finds it very difficult to implement a unified policy for restructuring of state monopolies and further liberalization of the energy and gas markets. After the two years in power, expectations towards development of reforms in restructuring, privatization and concessions are negative. No progress is seen in the concepts of privatization and concessions granting in transport, neither of restructuring or liquidation of losing state-owned companies.

Public finance. Despite the contributions to the EU budget, the consolidated budget of the country shows again a considerable surplus. The fiscal reserve also continues to grow and at the end of May reached the level of BGN 6.5 b.

Value added tax, again after EU accession, remains the most substantial revenue source for the budget and the difficulties of collection in the first months following the accession are to a great extent surmounted. Collection of corporate tax is in higher volumes – 75 per cent of the budgeted amount as a result of the reduced rate and growth of the economy.

Collection Rate
of Corporate
Tax



Foreign government and government-guaranteed debt continues its trend of decline and at the end of May is at the level of EUR 4.1 b which is by EUR

598 m less compared to December of last year. Despite the snowball growth of private foreign debt, financial stability is not threatened in the short-term.

Long-term financial stability of the country depends on speeding up the structural reforms: liberalization of the business environment, privatization, curtailing corruption, enhancing the efficiency of law-enforcement authorities and the judiciary, etc.

Social and health policies. The end of the first semester of 2007 is characterized by intensive pressure on behalf of a number of professional groups in the public sector for raising their salaries – physicians, teachers, social workers, etc. Claims for salary rise were made also by workers from the real sector, mainly employed in companies with state interest – public transport, metallurgy, etc. The additional expenses for salaries according to trade unions’ proposals were estimated at about BGN 1.2 b.

Risks for the
Competitive
Level of the
Cost of Labor



The new Ordinance on regulation of income in companies with over 50 per cent state interest also creates potential risks of subjectivism and liberalization of expenditures in the public sector. These conflicts can be expected to have an impact on the income policy by the end of the year and to create risks both for the balancing of the state budget and for the competitive level of the cost of labor. Extra benefits for continuous work were eliminated and replaced by an additional benefit for “acquired length of service and professional experience” but the determination of specific parameters of this benefit continues to generate contradictions among the social partners in the second quarter of the year. The proposal of the government for a 0.6 per cent minimum rate of the bonus received the well grounded criticism of employers’ organizations, as it blocks the mechanism of free negotiations with employees.

The Promised
Reduction of
Social Security
Contributions
Was Not Kept



Regardless of the positive trend in collection, the government did not fulfill its commitment to further decrease the social security contribution for retirement. Employers’ organizations view this measure as a precondition for salaries negotiations in the next year and categorically objected the intention of the government to keep the level of social security burden.

The government ensured priority indexation of pension benefits with a slightly higher percentage than the budgeted one (10 per cent) but the social effect of this measure was not clearly substantiated with arguments. The supplementary pension insurance demonstrated most successful development in the area of social security. The pace of assets growth in pension insurance companies exceeds the dynamics of the Bulgarian capital market and results in expansion of investments abroad.

Environmental policy. The emphases in environmental policy at the end of the semester are related to natural resources management, protection of biodiversity and preventive actions in environmental protection. All the three areas are subject to hot public conflicts whose resolution may prove to be a challenge to the capacity of government structures to represent the public interest and to undertake effective actions in its protection. Regulation of concession royalties for extraction of ores and minerals will contribute to

confirming the state's position in its relations with local and foreign investors. At the same time, legislative changes in this area will not have a decisive impact on finding a favorable way out of the existing conflict between the executive branch authorities and the interests of foreign investors in the mining sector.

Inadequate
Preparedness of
Administration to
Protect Public
Interest in the
Environment



The dialogue with representatives of the business on the occasion of implementation of the EU Directive 2004/35/EC on the responsibility of enterprises for environmental damages contributed to clarifying the conditions for the selection of financial guarantees for possible environmental damages and differentiation of the degrees of environmental risk in production.

Bulgarian companies demonstrate increased interest towards taking part in the absorption of EU Structural Funds. Project preparedness and absorption of the funds under Operational Programme Environment and the involvement of Bulgarian companies in this process are major priorities of MoEW.

The management mechanism of infrastructural projects under ISPA was improved through delegation of rights and responsibilities from the central to the local authorities. As a result, the significant delay in the absorption of funds under the pre-accession funds over the last year can be overcome, and launched projects – successfully completed.

Financial Sector



The Currency
Board is Stable

Monetary system. From the perspective of financial stability in the country, the Currency Board remains stable and unlikely to be affected even in case of serious deterioration of the balance of payments. Data collected so far indicate that a similar crisis is of low probability. Regardless of the increased deficit in the current account, foreign investments in the financial account manifest (so far) a powerful trend to off-set it in a ratio of almost one to one, creating conditions for balancing the balance of payments. At the same time, it can be demonstrated that even in the worst case scenario the liquidity of the Currency Board is sufficient to finance a deficit in the balance of payments within over 30 per cent of GDP for 3 months, a period long enough to transfer the illiquid portion of the currency reserve into a liquid type. In such a situation, we consider that the Currency Board stability is not seriously threatened.



The Banking
System
Remains Stable

Banking sector. Lending marks a significant growth in all type of loans, the leading portion being corporate lending (BGN 16.41 b or 68.3 per cent of all loans). At the end of March 2007 loans extended to households in our country amount to BGN 9.29 b which is by BGN 2.67 b more than in March 2006. Interest rates remain stable after Bulgaria's accession to the EU. BNB raised the minimum required reserves from 8 to 12 per cent.

BNB issued a license for payments via mobile phones to the System of Electronic Payments Bulgaria (SEP).

Leasing continues to enjoy a stable growth, the growth rates exceeding those of bank lending. Maturity of lease contracts is increasing.

The banking system remains stable, with a relative share of bad loans of 3.8 per cent. Clearly manifested is the trend that regardless of the significant growth of assets, the profit of the banking sector grows much slower. For the first quarter of 2006 the profit was BGN 213.66 m, and a year later – BGN 238.97 m. At the end of March 2007 the return on equity in the banking system is 5.27 per cent, and the return on assets – 0.54 per cent which shows a decline compared to March 2006.

Bulgaria's inflation is the only problem indicator for the accession of the country in the Eurozone. From the perspective of the requirements to keep it at a level not exceeding 1.5 points above the average for the three Member States with lower inflation rates and the time required to achieve such a level, 2010 – 2011 is the most realistic period in which the country may adopt the single European currency.

Insurance sector. The insurance market generated in 2006 revenues of BGN 1.25 b. Of these 15.4 per cent are realized in life insurance and 85 per cent – in general insurance. Collected premiums are by 17.2 per cent more than 2005 but the growth is still rather insufficient for the Bulgarian market, with regard to the low penetration rate of insurance services (only 2.6 per cent of GDP) and the high economic growth.

Insurance
Growth is
Insufficient



The share of property insurance is growing while revenues from financial insurance are still at low level.

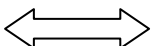
After Bulgaria signed the Green Card agreement, the questions remains whether regulatory bodies will manage to maintain the required coverage of Third Party Liability insurance. According to most recent data it is close to the admissible minimum and a realistic possibility exists of dropping below it which will endanger the stability of the Guarantee Fund.

A Law on Catastrophic Pull is being drafted to introduce mandatory insurance against disasters. Establishment of the pull will be funded through a World Bank loan.

Following the opening of the Bulgarian insurance market to EU 113 foreign insurer have applied to FSC for operations in Bulgaria. Most of them have expressed intentions to offer the insurance products General TPL and Miscellaneous Financial Losses.

Capital market. Trading on BSE in the first semester of 2007 is characterized by low activity levels and lack of clearly expressed trends. Both stock exchange indexes SOFIX and BG 40 fluctuated in fairly broad ranges; overall, each increase was followed by an analogical decline. Following the mid of May, as a result of the listing of three relatively big companies for the Bulgarian market – Kaolin AD, First Investment Bank AD, Corporate Commercial Bank AD, the activity on the exchange was recovered and the prices of many of the remaining items also marked a growth. On the one hand, the increased liquidity is encouraging but on the other hand, two not very favorable for the market facts are in place. First, the formation of trading by

The Market is
Liquid but
Remains
Underdeveloped



several companies speaks of the low market development, and second, empirically a decline is observed in the activity of newly registered company after the first euphoria of stepping out on the stock exchange. Parallel to this, according to the opinion of many participants, there are a number of strongly overvalued companies in the market and a possible sharp drop of their prices would have a negative impact on the market as a whole.

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BSE Capitalization
Is Growing

As a result of the new listings and the rise of remaining items prices, the market capitalization of the stock exchange exceeded BGN 20 b, in relation to the gross domestic product it reached 41 per cent. In this respect, the Bulgarian capital market is developing dynamically and in case this growth rate is maintained, a level of about 65 per cent would be reached within 2 or 3 years which is typical for developed EU markets. However, it should be borne in mind that the increase of capitalization is only one of the prerequisites for higher liquidity of the stock exchange and attention needs to be paid to the remaining ones like increase of freely traded stock of public companies.

At the end of the semester the National Assembly passed the Law on Financial Instruments Markets which was eagerly anticipated by the investors' community as much as this law directly implements the provisions of the radical EU Directive 2004/39 also known as MiFID. No unambiguous assessment can be made at this stage of the changes that will be provoked by the law, mainly due to the lack of secondary legislation. Nevertheless, the most substantial aspects of the law can already be seen and these are: dropping out the requirement that transactions with securities accepted for trading be concluded only on the regulated market (the so-called concentration rule); possibility to organize multilateral trading systems by an investment intermediary or a group of intermediaries, as well as by the regulated market; introduction of the figure of systematic participants executing customers' orders against themselves, and last but not least – requirements on disclosure of information related to concluded transactions and decentralization of disclosure outside regulated markets.

Structurally defining economic sectors

Energy. During the first three months of 2007 the unusually warm weather for the season resulted in lower volumes of generated electric power and heat compared to the first quarter of 2006. The saved electric power for heating assisted the stability of the energy system of the country after the decommissioning of units 3 and 4 of Kozloduy Nuclear Power Plant. In the beginning of the year the government made attempts to propose renegotiations of the terms and conditions of closing down of the two small reactors. In fact, what the Bulgarian user of electric power can benefit from the closing down of the two energy units is rather the expedient use of the already agreed funds for raising the energy efficiency in the country. This hides a huge unrealized potential for energy savings which more beneficial even than the production of the cheapest energy. **Bulgaria is lagging behind in the application of measures for efficient energy use both in industry and households.** The importance of CHPPs in the country was raised with the closing down of units

Low Efficiency
of Energy
Consumption
↓

3 and 4 of Kozloduy NPP. Varna CHPP declared its intentions in 2007 to increase its generation of electric power by 34 per cent. There is an enhanced investors' interest also to the construction of a new 700 MWt capacity in the Maritza East facility. In the beginning of 2007 the European Commission proposed a new common energy policy aimed at reducing the dependence from external energy supplies and at curtailing harmful emissions in the atmosphere generated by the energy sector. The share of energy from renewable energy sources (RES) is envisaged to be increased up to 20 per cent of the gross energy consumption by 2020. Within the negotiations for Bulgaria's accession to EU a commitment was made by our country that the share of RES would reach 11 per cent by 2010. In 2006 it was about 1 per cent, not including power generation by hydro-power plants. The lack of support by the government for implementation of RES projects makes impossible the achievement of this commitment by 2010 and the objectives of the common EU policy by 2020.

The Crisis in BDZ Continues



Transport. The development of a Sectoral Operational Programme Transport 2007-2013 is among the basic priorities of the government policy and planning in the transport sector. The planned allocation of funds in the operational programme stresses on the development of road infrastructure in the country. The largest project to be implemented with EU funds is the construction of Struma high way. There are no sufficient funds for maintenance of the existing road infrastructure in the country. Funding for this purpose will be provided under a road rehabilitation project from the World Bank. The objective of the project is to cut down road transportation costs through improvement of condition and quality of the road network during the first year after Bulgaria's accession to the European Union.

The crisis in the state-own railways remains without solution. The deteriorating quality of the provided transport service leads to losing solvent passengers. The state railways are preferred mainly by passengers with privileged monthly tickets. For BDZ this means operating at a loss even with relatively high occupancy of seats in trains. The crisis of shortage of cargo carriages is deepening.

Bulgarian Cargo Aviation is in Collapse



The EU accession of Bulgaria proved fatal for the Bulgarian cargo aviation. The Civil Aviation Administration (CAA) revoked the licenses of aviation operators of Bulgarian companies involved in the transportation of cargos. Regardless of the investments made in the technical condition of aircrafts, aviation companies did not manage to meet EU standards. Thus, Bulgarian aviation lost its positions in the market of cargo air transport.

Construction and real property. In the beginning of 2007 construction recovered its accelerated rate of growth. The real growth of value added in the sector in the first quarter was 15.5 per cent, again much higher than the one in the economy as a whole. Thus, the construction sector keeps on being one of the main drivers of total economic growth. This favorable trend for the branch was accompanied by higher optimism of entrepreneurs. During the period April – June 2007 the index of business climate in construction continues to go up.



Construction

Continues to Grow

High level of investments intensiveness is observable again in the sector of construction in 2007. Fixed assets acquisitions costs in the first quarter of 2007 are almost double the ones for the same period of 2006. Like in the previous years construction remains attractive for foreign investments, too, and they continue to grow at the background of decreasing flows to the remaining economic sectors.

General attitudes related to the country's accession to EU influenced also the housing property market. Houses' prices went up by 9.3 per cent only for the first quarter of 2007 according to NSI official data.

The Investments Promotion Act was amended and the incentives provided there would not be valid for investment projects in the area of housing construction and tourism.

High technologies. The most interesting point for the ITC sector over the last months is the launch of the first in our country fund for risk investments in the area of information technology – NEVEQ. The fund's capital is EUR 22.5 m and with its establishment it got involved with a promising project investing USD 3 m in the travel services portal – www.lessno.com.

The emergence of such a fund is welcomed with admirations by the IT sector and many experts think that the implementation of this initiative is even a bit delayed.

The last edition of the newspaper Computerworld – Top 100 ITC companies in Bulgaria indicates that the total value of the ITC business and telecom services in 2006 amounts to BGN 3.908 b and is about 9 per cent higher than the previous year. An enjoyable fact is that ITC exports by Bulgarian companies have grown by over 60 per cent to reach EUR 64.8 m.

Tourism. The number of EU citizens who visited the country in the period January – May 2007 is growing. At the same time, a decline is observed of tourists from some non-EU countries mostly due to the introduction of visas.

Revenues from foreign tourists are increasing – for the period January-April 2007 these reached EUR 336.7 m which is by 14 per cent higher than the same period of last year.

Balance in Tourism is Negative



The number of Bulgarian citizens going on a vacation abroad is also increasing. Expenses of Bulgarian citizens abroad are considerably grown and exceed EUR 389 m for the first four months of the year. The balance in tourism for this period is negative at the amount of EUR 52 m.

EU remains and will continue to be the main tourist market for Bulgaria. During the present season close to 80 per cent of tourists at the seaside resorts will be from EU Member States, and the number of tourists from new markets will be growing (mainly Romanian at the expense of German tourists).

The expectations of those employed in the sector for the active summer season are optimistic. It is worth noting, however, that the long known problems of Bulgarian tourism are deepening further and this fact questions positive results. What we mean is the excessive property development in large seaside resorts; serious conflicts between economic interests and the need for preservation of environmental balance; low quality of road infrastructure; lack of waste water treatment plants, water supply and sewer; shortage of skilled staff; low quality of service; uncertainties about the concessions of some of the beaches; numerous stores and stands impeding additionally the traffic, etc.

The potential of alternative forms of tourism is increasing appreciated and their role for the prosperity of regions inland the country. Particularly good prospects are offered by spa tourism and it is also in the focus of interest of foreign investors. Operational Programme Regional Development offers considerable support for the development of tourism in small towns and villages. Municipalities will be the main subjects that can apply with project proposals for funding under this programme. It provides for over EUR 204.1 m for improvement of tourist services and advertising.

**A Hard Year
Seems to be
Coming for
Farming**



Agriculture. This year seems to prove very difficult for farming. On the one hand, the unfavorable meteorological conditions over the last 5 or 6 months once again displayed the lack of a strict organization to respond to risks, as well as the attitude of farmers to look for non-market means to resolve their problems. Crops are not devastated, harvested wheat (over 2 m tons) is by 30 per cent less than last year but will suffice to ensure the grain balance, and increased demand for production of bio fuels and deteriorated international market situation pushed up prices substantially (twice versus last year). Thus, farmers' hopes for higher income would not be unrealistic.

On the other hand, the introduction of the regulations of EU Common Agricultural Policy burdens both the administration which does not always manage to prepare and publish the required documents under the respective measures, and the farmers who are not in the position to deal with the avalanche of information and the strict requirements. Almost 79 thousand farmers have registered themselves for receiving of direct payments for about 34 m decars of identified land. The inspections made found cases of overlapping of registered land. All discrepancies need to be remedied for the system to start working and to define the exact amount of subsidies. Together with the direct grant payments farmers will receive the envisaged national co-payments.

**Administrative
Problems in the
Subsidies System**



Uncertainty is created by the lack of accreditation of Agriculture State Fund as a Paying Agency. Even if the full amount of funds for direct payments per unit of surface area and measures in support of individual farming sectors are not received, the positive effect of introduction of the requirements and compliance with the terms and conditions is already helpful with regard to overcoming the fragmentation and lack of planning in agriculture, uniting the efforts of small producers, implementation of new machinery and compliance with the technology of agro-melioration measures which in the end results in improving the competitiveness of agricultural produce.

EU Funds and Regional Policy

The current year is particularly important from the perspective of preparation of the process of EU funds absorption. In June the National Strategic Reference Framework (NSRF) was approved and formally signed by representatives of the Bulgarian government and EC. Operational programmes are still to be approved and this is expected to be done by the fall of 2007.

The Ministry of Finance organized a large-scale campaign to present the most important documents (NSRF and OP) before the business and civil society in the country. During the campaign clarifications were given with regard to major points related to the use of the Structural Funds and the Cohesion Fund of EU in compliance with the priorities of the country for economic development, and with the major goals and objectives of the EU. The government adopted important documents for the absorption of EU funds that regulate grants from the Structural Funds and the Cohesion Fund. Decree N 121 of the Council of Ministers of 31st May 2007 was adopted and promulgated on the procedures for provision of grants to projects within OP, co-funded by the structural and the Cohesion Fund and PHARE Programme of EU. The application forms for the grants and for funding are ready.

A relevant point in the integration process is the envisaged opportunity for banks to take part in the valuation of projects under EU structural and Cohesions Fund (within OP Competitiveness). Negotiations are being held with the banks that will provide investment support to enterprises and subsequently will assess the proposed business plans.